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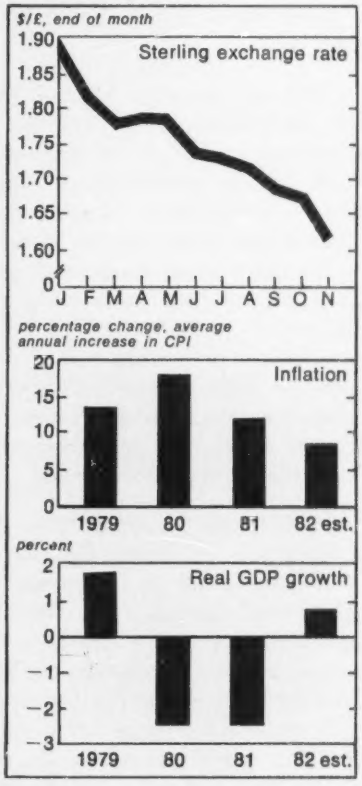
Pressure on the Pound Could Force U.K. Policy Shift

The striking decline of the pound sterling over the past few weeks has given British policymakers reason for pause. Encouraged by 1982's more promising inflation outlook, the Thatcher government had begun to relax some of the tough economic policies that had made life in Britain so unpleasant in recent years. Inflation had finally begun to respond rather dramatically to past policies and was expected to decelerate to around 6% by year-end. Even the money supply was growing within the government's target band. With unemployment still at a postwar high, the Bank of England was nudging interest rates down ahead of—although not in contradiction to—market forces. The government also announced a reduction in employers' contributions to social security and indicated that the budget due in early 1983 would include major personal income-tax cuts.

The unexpected steepness of sterling's November decline, however, may make it difficult to continue on such a course. By the close of business on November 30, the pound had slipped to $1.62, DM4.01, and a trade-weighted index of 86.7 after finishing October at $1.68, DM4.29, and an index of 92.5. To be sure, the fall in sterling was welcome to a degree. British industrialists had argued for some time that the pound was so overvalued that they could not compete in world markets. Moreover, the government was growing increasingly concerned about a possible rise in import penetration. Recent official forecasts have suggested that Britain's balance of payments will be back in deficit before the end of 1983. And several government spokesmen—including the chancellor of the exchequer—have indicated a willingness to tolerate some sterling weakness. The speed and size of the November fall, however, has unfortunately brought back worrisome memories of the pound's uncontrollable decline in 1976.

The new measures already instituted suggest that U.K. policies have become relatively less restrictive than those elsewhere in the world; consequently, the risks associated with the holding of sterling have gone up. Nevertheless, it is still difficult to pinpoint any particular reason why the selloff of the pound should have come just now. The government clearly hopes that the small rise in interest rates announced on November 26 will prevent sterling from falling further. For if the decline continues to a point that would threaten renewed inflation, the authorities will be forced to put current policies into reverse and again bolster the interest-rate differential in favor of sterling. However, if interest rates fall elsewhere in the world and if expectations of U.K. inflation do not become too pessimistic, it may still be possible to renew the downward trend in British interest rates.

Selected U.K. economic indicators



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Rebound of German economy likely to be delayed until second half of 1983.

The recession in Germany is deepening. Industrial production in the July-September quarter fell at a seasonally adjusted quarterly rate of 2.8% to reach the lowest level since the end of 1978. Third-quarter industrial order figures also make dismal reading: Foreign order volume fell at a quarterly rate of 4.5%, while domestic order volume declined by 3%. Contrary to earlier official expectations, final demand—both in Germany and abroad—is falling and industrialists now appear to be cutting inventories built up in the first quarter. The seasonally adjusted unemployment rate has risen from 6.7% at the beginning of this year to 8.4% in October and consumer confidence is falling. Against this background, fiscal policy is expected to be tightened somewhat next year, although monetary policy has been eased significantly. Even so, the government's latest forecasts—a 1% decline in real GNP this year and zero growth next year—are looking increasingly optimistic for 1982 and imply a significant recovery in the second half of 1983.

Portugal unable to rein in current-account deficit, despite other policy successes.

Portugal's economy has yet to show that it has adjusted successfully to current world economic conditions. In 1981, in the face of weak export demand, falling remittances, and lower tourist revenues, the current account of the balance of payments widened to $2.7 billion—a high 12.4% of GDP. This year, because of the continued weakness of the world economy, export volume is expected to grow only 4%, while remittances and tourist income are again set to fall. Last April the government tightened monetary policy and in June the escudo was devalued by 9.3%. Eventually, these measures should inhibit the currently buoyant import growth, but they will be insufficient to prevent the current-account deficit from reaching $3 billion—13% of GDP—for the year. The Portuguese government, however, must be credited with some successes: Consumer price inflation has already moderated to a year-on-year rate of 20.7% in September from a peak of 27.1% last March; economic growth this year should exceed the 1.8% achieved in 1981; and the public-sector deficit should fall to about 10% of GDP in 1982 from 11.4% last year.

Marginal progress made in bringing down Brazilian inflation.

Brazil's rate of inflation has come down a little as a consequence of a slowing economy, monetary restraints, and lower agricultural prices. For the 12-month period ending in October, the rate of increase in the general price index was almost 96%, down from a rate of 103.4% for the corresponding period last year. The rate of wholesale price inflation dropped even sharper—down to 94% for the similar period of 1982 versus 102% a year earlier. Falling demand, prompted by government efforts to improve Brazil's balance-of-payments position, has helped to bring down the rate of inflation, as have moderating agricultural prices. Moreover, manufacturing production declined by 7.5% in the first eight months of the year. In addition, monetary policy has turned more restrictive, with increased reserve requirements for demand and time deposits. Nevertheless, the pressure on prices from wage adjustments and a higher devaluation rate is still strong. Brazil still has some distance to go before prices can be brought down to reasonable levels, but the effort is being made.

Norway's 1983 budget far less conservative than had been expected.

Norway's budget for 1983 is now taking shape. Although the conservative government was elected in the autumn of 1981, there was insufficient time to produce a budget for 1982 and the government was forced to implement the bulk of the programs proposed by their labor predecessors. Thus, the 1983 budget has provided the first test of the conservatives' promise to cut taxes and roll back the influence of the state on Norwegian business. Unfortunately however, oil prices have dropped considerably since the 1981 election and prospects for the rest of industry have been damaged by Sweden's surprise 16% devaluation in October. As a result, the budget contains far fewer radical changes than had been expected. Income taxes have been cut a little and only partially offset by higher sales taxes and higher charges for public services. Government spending, however, will be higher than anticipated and there will be special subsidies

for those industries most affected by the Swedish devaluation, such as the forest products industries, textiles, clothing, and furniture. The budget's forecasts point to a 1% increase in GDP in 1983 after a 1.4% decline in 1982. Private consumption is projected to rise 2.5% this year. Despite the stepped-up activity, the current-account surplus is forecast to increase from 2.75 billion kroner in 1982 to kr 3.65 billion next year. One worrying cloud on the horizon is inflation, which is expected to run at 9.5% in 1983 after 11% this year. These rates are higher than those elsewhere in Europe and may raise doubts about Norway's longer-term trade competitiveness.

Japan's fiscal austerity to continue under Nakasone.

On November 25, Japan's ruling Liberal Democratic Party elected Yasuhiro Nakasone to succeed Zenko Suzuki as president of the party and prime minister of Japan. Nakasone, who received support from both the powerful Suzuki and Tanaka factions, most recently was director general of the Administrative Management Agency and hence was in charge of the government's program of administrative reform. Nakasone is expected to advocate a continuation of the general policy of fiscal austerity and has reaffirmed Suzuki's pledge to reconstruct government finances without increasing taxes. However, large revenue shortfalls arising from the slowdown in the Japanese economy may force him to back away from Suzuki's commitment to balance the budget by fiscal 1984. The completion of the election process will allow the Japanese Diet to get on with the passage of the fiscal 1982 supplementary budget—including the fiscal stimulus measures announced in October—which had been temporarily delayed because of the election.

Hong Kong budget victim of falling land prices.

Hong Kong's economic problems continue to grow. Land prices in the colony have plummeted, reflecting reduced inflation expectations and the uncertainty surrounding the colony's future after 1997. As a result, a number of real property companies have failed and it has become virtually impossible for Hong Kong to balance its budget for fiscal 1982/83. Government land sales were accelerated in 1980, producing 35% of Hong Kong's revenues in fiscal 1980/81 and 23% in 1981/82. Unfortunately, however, the drop in land prices has reduced these revenues and this will produce the first public-sector budget deficit since 1974/75. In the first five months of fiscal 1982/83, which began in April, the shortfall amounted to $HK4.66 billion. This compared with a surplus of $HK581.8 million in the same period last year. Hong Kong's reserves of $HK22 billion can easily cover this year's gap, but not a string of such deficits. Thus, Hong Kong Financial Secretary Bremridge has suggested it may be wise to postpone some large public projects, such as a proposed new airport, until government cash flows can be examined more carefully.

More modest growth seen for OPEC foreign assets.

The accumulated gross foreign assets of the 13 OPEC nations totalled nearly $434 billion as of the end of 1981—up sharply from $368 billion in 1980. Some 77% of last year's total was officially-held, and, of that, about three-quarters were assets accumulated by the governments of Saudi Arabia, Kuwait, the United Arab Emirates, and Qatar. The available data on the deployment of these funds worldwide indicate that only $377 billion has actually been identified; the balance flowed into unidentified placements such as Swiss fiduciary accounts, unrecorded purchases of gold, and unreported investments. Of the identified placements, $154 billion was deposited in banks, mainly in the Eurocurrency market. The balance was directed into other, primarily longer-term investments such as purchases of government and corporate securities, direct investments, and loans to other nations and international organizations. The share of bank deposits in identified placements has plummeted in recent years—from 66% in 1979 to 7% last year. With the surpluses of the four Arab Gulf nations that account for the bulk of these funds projected to drop sharply this year, OPEC's gross foreign assets are expected to grow more modestly in 1982 to a maximum of $445-450 billion by year-end.

Money Demand and the Stock Market

The 16% growth rate in M1 from August through October has confounded monetary analysts, most of whom had predicted that money would be far more contained over this period because of the anemic state of the economy. They have attempted to explain the unexpected money bulge by attributing it either to an above-normal precautionary demand for money in a time of high uncertainty or to distortions resulting from such "technical" influences as maturing All-Savers certificates and an inaccurate seasonal adjustment process used by the Federal Reserve. These explanations, however, cannot completely account for the discrepancies. To do so, it is necessary to turn to a consideration that most monetary analysts have tended to overlook: the unusually large volume of stock market transactions that has taken place over the past few months.

Money demand—the public's desire to hold money balances—is determined primarily by two forces. One is the rate of return on relevant substitute assets. This is a measure of income foregone by holding money rather than these assets. When the yield of financial assets rises, the demand for money falls. The second is the services that money provides, especially the facilitation of transactions. The larger the volume of transactions, the greater the amount of money that must be held to perform them. Most forecasting models of money demand, however, assume that transactions are proportional to gross national product, so that higher GNP levels generate more transactions, which in turn require greater money balances to finance them. But it may not be appropriate to use GNP as a complete measure of transactions.

Since August, the public has appeared to want to hold much more money at the prevailing level of interest rates and GNP than historical experience would suggest. Recent research by the Chase Economics Group suggests that a large portion of this abnormally high money demand can be explained by using a more complete concept than GNP as an estimate of transactions. GNP, after all, does not account for transactions in the financial markets, such as the recent volume surge in the stock and bond markets.

When the stock market boom that began in midsummer is used to help explain money demand, the surprising growth in M1 is not nearly so surprising. In fact, the simple addition of a variable to capture the value of transactions on the New York Stock Exchange explains nearly all the "excess" money demanded in October—that is, the difference between actual money growth and the amount predicted by standard models. This implies that money may tend to overshoot market predictions in the future during times of surges in stock market volume.

Robert S. Smith

Asia and Oceania — Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF PA				
			6 months ending	12-month change	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IM credit, m lions of dol
Asia	Bangladesh	Balance-of-payments financing constraint will hold economic growth to low level.	June	−15%	11.6*	$ 126	Sept.	170	+ 15%	0.8	404
	Burma	Shortfalls in onshore oil production leading to resumption of offshore exploration.	June	−12%	5.8*	159	Oct.	84	− 66%	2.4	49
	China, People's Republic	Industrial growth of 7% and a record grain harvest expected in 1982.	June	+10%	260.0	260	June	7,287	+ 91%	4.0	492
	Hong Kong	Financial jitters, failures of property companies are fallout from unresolved 1997 problem.	June	+ 7%	24.2	4,695	n. a.	—	—	—	—
	India	Government measures spurring private-sector investment boom.	June	+10%	161.4*	236	June	4,279	− 27%	3.8	1,833
	Indonesia	Real economic growth forecast at 4% in 1982, 6% in 1983 with 10% inflation.	Dec. '81	+ 3%	81.5	542	Oct.	3,313	− 46%	n. a.	0
	Japan	Nakasone expected to continue policies of administrative reform and fiscal austerity.	Sept.	− 1%	1,130.3	9,607	Oct.	22,860	− 19%	2.2	0
	Korea	Industrial production has reversed its decline and begun to rise.	Sept.	+ 9%	63.4	1,638	Oct.	2,703	0	1.3	1,222
	Malaysia	Budget for 1983 calls for reduced development spending, higher consumption taxes.	May	+ 5%	23.6	1,638	Aug.	3,164	− 17%	2.8	262
	Pakistan	Significant deregulation of domestic industry under consideration.	July	+ 4%	30.7*	359	Oct.	999	+ 42%	2.2	1,157
	Philippines	Real GDP up 2.9% in first half of 1982 from year ago.	May	− 4%	38.6	780	Oct.	1,708	− 14%	2.7	821
	Singapore	Slowdown in world trade causes growth forecasts to be slashed.	Aug.	+ 3%	12.5	5,121	July	7,630†	+ 14%	1.8	0
	Sri Lanka	Presidential election results show support for continuation of Jayewardene's open economic policies.	April	+ 8%	4.4	291	Oct.	302	+ 29%	2.2	376
	Taiwan	Industrial production up 2.8% in August; year-over-year inflation quite moderate.	May	+ 1%	45.5	2,530	June	7,525	+125%	4.3	0
	Thailand	Business depressed by world recession, poor domestic purchasing power owing to low commodity prices.	June	+ 5%	36.1	750	Oct.	1,307	− 6%	1.9	634
Oceania	Australia	Drought in eastern Australia produces sharp drop in farm income.	Sept.	+13%	158.8	10,686	Oct.	4,976	+198%	2.3	0
	New Zealand	Business conditions expected to remain depressed for the next six to nine months.	Sept.	+13%	24.4*	7,858	Oct.	704	+ 41%	1.4	9
	Papua New Guinea	Export-led recession continues as commodity prices fail to recover.	June	−19%	2.6**	867	Oct.	396	− 7%	3.7	48

*Fiscal year **1980 †includes gold holdings

Government Policy Shifting Focus

Dramatic movements in financial markets over the past several weeks indicate that what were once only slightly nagging fears about U.S. policymakers' commitment to reduce budget deficits and fight inflation have become grave doubts. During the past month, the value of the dollar has fallen by more than 10% against the yen and about 6% against the mark. Moreover, the price of gold jumped from under $390 per troy ounce in early October to $440 on December 1. And the Eurodollar yield curve out to one year has turned somewhat steeper. It is still too early to say conclusively that these judgments about the government's resolve are correct. Nevertheless, Congress, the White House, and the Federal Reserve cannot afford to ignore these market warnings.

With unemployment moving toward 11%, it is clear that, politically, the most pressing economic problem is now unemployment rather than inflation or budget deficits. President Reagan recently considered moving July's scheduled reduction in personal income taxes to January, and has proposed a new public works program to create jobs. Congress, in its post-election "lame-duck" session, is considering a number of measures to stimulate the economy. Meanwhile, the Fed continues to permit monetary growth far above target.

Looking back at history, it is not surprising that this shift in emphasis has occurred. Monetary policy for the last 30 years has consisted of alternating periods of ease and relative restraint, while budgetary policy has generally been expansive. This combination has resulted in the ratcheting upward of inflation.

What *is* surprising in terms of history is that the Fed held to its restrictive stance as long as it did and that the push for stimulative government spending did not come sooner. Still, policymakers seem hesitant to throw away the gains made in slowing inflation—perhaps because the costs incurred in achieving the advances have been so great. The Fed, for instance, insists that its tolerance of excessive money growth relative to target is only a temporary accommodation of increased demand for liquidity. In addition, current projections that budget deficits will be in the $150-250 billion range over the next several years appear to be holding some rein on fiscal policy. For example, the administration felt compelled to link its proposed public-works jobs program with its own funding source—an increase in the excise tax on gasoline. And the proposal to advance the income-tax cut met with general disfavor—chiefly because it would have worsened the deficit for fiscal 1983.

Nevertheless, policymakers may yet succumb to political pressures to overstimulate the economy. Congress is considering resolutions that would force the Fed to target interest rates--presumably at a lower level. And jobs bills more comprehensive than the one proposed by the President are also on its calendar. Until the fate of these and other proposals is known, financial-market participants have plenty of cause for concern.

Douglas L. Bendt

MENTS	MONEY AND BANKING							COUNTRIES
	12-month changes				exchange rate in U.S. dollars	change from year earlier		
s current influences on payments	latest data	consumer prices	latest data	money supply(M1)	December 1, 1982		current monetary conditions	
Imports likely to be severely constrained again this year.	Aug.	+ 7%	June	+ 1%	.0410	−22%	Government has resisted further taka depreciation.	Bangladesh
Depressed commodity prices, particularly for rice, hurting export earnings.	June	+ 6%	Feb.	+12%	.1260	− 7%	Government remains committed to fixed exchange rate.	Burma
Import growth accelerating after $2.4 billion trade surplus in first half.	Dec. '81	+ 3%	June	+12%	.5080	−10%	Investment growth to boost deficits in 1983.	China, People's Republic
Lower export growth reflects recession in overseas markets.	Sept.	+ 9%	July	+ 6%	.1500	−16%	Weak HK dollar means high interest rates.	Hong Kong
Trade deficit narrows in first five months of fiscal 1982/83.	Aug.	+ 7%	March	+ 7%	.1030	− 6%	Credit generally restrictive but eased slightly for exports.	India
Oil prices cut $.47-$1.90 per barrel to stimulate sales.	Aug.	+ 8%	May	+30%	.0015	− 6%	Money supply growth expected to be about 25% this year.	Indonesia
Trade friction with U.S. threatens to heat up again.	Oct.	+ 3%	Sept.	+ 8%	.0040	−14%	Net capital outflow slows with narrowing rate differentials.	Japan
Imports 6% lower, exports 4% higher, compared to last year.	Oct.	+ 2%	June	+14%	.0014	− 7%	Money grew at 39% annual rate in first two quarters.	Korea
Export duties reduced, other incentives adopted to encourage exports.	Aug.	+ 5%	Aug.	+11%	.4237	− 5%	Money, credit growth slower this year than in 1981.	Malaysia
July-Sept. exports in dollars down 15% from year ago.	July	+ 6%	Aug.	+14%	.0800	−22%	Credit remains restrictive; rupee depreciation resumed.	Pakistan
Payments deficit ballooned to $747 million in first nine months.	June	+13%	Aug.	− 2%	.1150	− 9%	Term deposits increase strongly.	Philippines
Foreign currency reserves heading upwards; trade-weighted S$ strong.	Sept.	+ 1%	July	+12%	.4560	− 7%	Moderate money growth—4.4% in first half—continues.	Singapore
Tea prices improve; imports sluggish; remittances strong.	June	+11%	May	+21%	.0473	− 9%	Private-sector credit demand slack.	Sri Lanka
Trade balance shows strong surplus.	Sept.	+ 2%	July	+19%	.0245	−13%	Year-over-year money growth high but falling.	Taiwan
Across-the-board 10% import surcharge introduced; some tariffs reduced.	Sept.	+ 4%	June	+ 6%	.0450	− 2%	Interest rates continue to fall.	Thailand
Inflows of Japanese capital increase reserves, support Australian dollar.	June	+11%	Aug.	− 1%	.9601	−16%	Monetary conditions remain tight.	Australia
Common market with Australia will stimulate trade across the Tasman Sea.	June	+17%	March	+15%	.7200	−14%	Interest rates down from peaks by 250-500 basis points.	New Zealand
Copper prices remain extremely depressed, but are expected to improve.	Feb.	+ 5%	Aug.	− 7%	1.2953	−11%	Real interest rates high; M1 fell in first half.	Papua New Guinea

World Interest Rates

market rates of Dec. 1, 1982; bond yields as of Nov. 26, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	9.00	11.05 December 2	10.00 intervention rate	11.50	9.50	5.00 December 2	18.00 penalty rate 21.00	5.50	4.50 December 2	5.50
Day-to-Day Money	9.004 December 2	15.50	10.75	9.20	13.25	7.05	19.00	6.25	1.75 1-month Euro-Swiss fr. rate	6.75
Treasury Bills 91-day, Middle Rates	8.24	10.80	9.75	12.25	n. a.	n. a.	18.75 87 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	8.75 finance paper discount basis	11.00 finance paper 15% tax w/h	9.40	11.40 Certified	13.25 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.60	10.90 15% tax w/h	9.875	11.40 Certified	not traded	8.05	19.90	no market	3.875	no market
Government Bonds Long-term, new and old issues, average yield	10.74	12.60	11.15	8.585	15.125	8.17	20.05	8.68	4.27	8.05
Industrial Bonds prime, long-term, new and old issues, average yield	11.70 Aa Industrials	13.25	12.34	15.096	15.96	8.24	20.06	9.21	5.64	6.82
Bank Short-Term Rate to Best Borrowers (prime rate)	11.50	13.00	11.00	15.50	15.20	11.50	20.75 ⅛ qtrly fee on outstdng.	8.00	8.50	6.00
Bank Time Deposits 3-month	8.50 Cert. of Dep.	11.05	10.00	12.15	13.25	7.10	11.50	6.875 large deposits	3.00 residents only	3.75
Eurocurrencies 3-month, asked	9.875	11.375	10.1875	no market	19.25	7.125	no market	6.5625	3.875	7.50
Exchange Rates—in U.S.$ rates floating against the $	—	.8065	1.6325	.02075	.1437	.4057	.0007	.3693	.4732	.00402
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.40 *D*	.20 *D*	3.30 *D*	9.50 *D*	2.80 *P*	13.00 *D*	3.10 *P*	5.80 *P*	2.50 *P*

Eurodollar Deposits
(London, interbank, bid)
December 2

7-day	9.0625
1-month	9.375
3-month	9.75
6-month	10.0625

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.176
U.S.-Canada Treasury Bills	−0.733
U.S.-Canada Finance Co. Paper	−0.699
Eurodollars-U.K. Local Auth. Deposits	+0.200

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.25
Over 7 yrs.	11.50
DM Bonds	
7 yrs. and under	7.75
Over 7 yrs.	8.00

Gold Price
London afternoon fixing
440.25
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Oct.) 5.1	(Oct.) 10.0	(Oct.) 6.8	(Oct.) 9.3	(Oct.) 4.9	(Oct.) 17.2	(Oct.) 6.2	(Sept.) 3.2
Industrial production*	(Oct.) −8.6	(Aug.) −11.0	(Sept.) −0.1	(Sept.) −3.6	(Sept.) −6.5	(Sept.) −5.9	(June) −2.7	(Aug.) 1.2
Trade balance† *(billions of local currency units)*	(Oct.) $5.33	(Sept.) C$1.75	(Oct.) £0.29	(Oct.) −FF5.80	(Oct.) DM3.99	(Sept.) −Lit.2,179	(Oct.) −SF0.375	(Oct.) ¥540
Money supply (M1)*	(Oct.) 9.0	(Oct.) 5.0	(Aug.) 15.0	(June) 15.0	(Aug.) 3.2	(June) 9.0	(July) 3.5	(Aug.) 5.3
Velocity of money (M1)*	(Sept.) −6.5	(June) 1.5	(March) −5.3	(Dec. '81) 0**	(March) 3.1	(June) 7.6**	n. a.	(June) −1.4
Reserves minus gold *($ million, change from previous month)*	(Oct.) 720	(Oct.) −185	(Oct.) 45	(Sept.) −949	(Oct.) 1,404	(Oct.) −1,226	(Oct.) −301	(Oct.) −1,149

* Percent change from 12 months earlier. ** based on GDP † Figures are only for the month indicated.

Slower Growth for the Euromarkets

Eurocurrency bank lending appears to be leveling off. Data from the Bank for International Settlements show that net lending—that is, excluding most interbank positions—picked up somewhat in the second quarter from the first (see table, page 8). But net-lending growth in the first half of the year was still well below that of the second half of 1981. Furthermore, preliminary evidence suggests that net Eurocurrency claims may well have fallen in the third quarter.

Any analysis of Euromarket activity must take into account the high degree of integration that exists between the Euromarkets and domestic money markets —particularly in the dollar sector. This is demonstrated by the narow—but variable—"arbitrage tunnel" between Euro and domestic interest rates on deposits of equal maturity and by the variability of U.S. banks' net positions vis-a-vis their foreign branches. The arbitrage tunnel is the band within which the interest-rate differential between domestic and Eurodollar deposits can fluctuate before arbitrage becomes profitable. The fact that there have been periods when the differential remained outside the tunnel simply confirms that the substitutability between domestic and offshore deposits, while close, is less than perfect.

This relation between Euro and domestic markets suggests that two principal forces underlie the growth of the Euromarkets: The first is the size of total credit expansion—domestic and foreign—by the major developed economies. The second is the distribution of deposit and credit flows between domestic and offshore markets. Credit expansion is determined primarily by the monetary policies of the major industrial countries, even though the impact of a change in policy on overall credit growth is neither straightforward nor immediate. The distribution of deposit and credit flows between domestic and offshore markets, on the other hand, is influenced by a number of economic variables. These include risk perceptions, market depth at the preferred maturities, economies of scale in transactions costs, the costs of gathering and disseminating information on creditworthiness, differences in the regulatory environments of domestic and offshore institutions, and convenience factors such as time zones.

The advantages of the Euromarkets in many of these areas led to their rapid growth in the 1960s and 1970s, and to their institutionalized primacy as vehicles for both international capital flows and the short-term financing of international trade. The Euromarkets have also become the preferred habitat for many official holders of short-term financial assets. As a result, an additional set of influences on the distribution of credit flows has emerged: imbalances in the world's (gross) balances of international payments, the relative asset and maturity preferences of capital-exporting countries, and the volume of international trade and gross capital flows. The most obvious example of balance-of-payments flows and asset preferences was the recycling—largely through the Euromarkets—of the OPEC current-account surpluses.

Behind the recent slowdown

This framework can be used to explain the recent slowdown in the growth of the Euromarkets. Monetary policies were tightened in the world's major economies following the second oil-price shock. The impact of such a policy shift on narrowly defined money—currency and demand deposits—may occur fairly quickly (although even this effect was almost certainly mitigated in the current cycle by an uncertainty-related rise in liquidity preference). But the effect on the growth of national and international credit is not felt until after some delay. Indeed, in the short run, a tightening of monetary policy by any means other than direct credit control frequently raises credit growth, as companies seek to finance unintended inventory build-ups or higher interest charges. After a while, economic activity and inflation decline and credit growth slows. This stage in the cycle was reached by 1982.

Furthermore, by mid-1982 there appeared to have been a reassessment of international financial risks following the failure of several small banks and the well-publicized financial difficulties of a number of large industrial concerns. This culminated in the so-called "flight to quality" seen in the late summer. This movement then led not only to a widening of the gap between yields on private (including banks') liabilities and those on government liabilities, but also to a greater dispersion of yields within different groups of private-sector liabilities.

In general, the extent to which credit flows respond to these altered risk perceptions depends on the interest sensitivity of loan demand. Hence, the recent renewed decline of these "deposit risk spreads" could signify either an abatement of the concern with risk or a highly interest-responsive demand for loans. However, in the absence of offsetting forces, a flight to quality would reduce the growth of bank credits, although it is uncertain by how much.

In addition, several considerations specific to the Euromarkets have come into play over the past several months:

- First, heightened risk premiums appear to have been attached to Eurodollar deposits. Yields have been above the arbitrage tunnel since early 1981. And they rose sharply in the wake of the failure of the Banco Ambrosiano in June and subsequent market

Slower Growth for the Euromarkets *(continued from page 7)*

doubts about the correct interpretation of the Basel Concordat.

- Second, the growth in assets whose preferred habitat had been the Euromarket slowed sharply; the combined current-account surpluses of Saudi Arabia, Kuwait, and the United Arab Emirates declined from some $68 billion in 1981 to an estimated $20 billion this year.
- Third, a rise in the perceived risk of loans to developing countries—the result of the process of disinflation in the industrialized countries—spurred a sharp reduction in such lending. This had a disproportionately large effect on the Euromarkets, since these are now the principal vehicles for such international lending.
- Finally, the decline in the growth of international trade—and more recently in the actual level of trade volumes—may also have contributed to a weakening of Euromarket growth. However, this may well have been offset by an increase in gross capital flows among developed countries in response to greater interest and exchange-rate volatility.

The Euromarket outlook

For 1983, a further reduction in Euromarket growth seems likely. For one thing, most of the forces affecting 1982 will still be at work. And although there is some evidence that monetary policy is being relaxed in the world's major financial centers, these policy shifts will not have an immediate impact on credit growth; delays work on the upswing of the economic cycle as well as on the downswing. Moreover, any recovery in economic activity in 1983 will at best be sluggish, and inflation will fall somewhat further. Consequently, credit flows in the industrial world are likely to decelerate over the near term.

The developing countries will continue to have difficulties in attracting private capital flows—albeit less so than in the second half of 1982—and this effect alone will dampen Euromarket growth. Furthermore, since official flows are unlikely to compensate for the reduction in private capital flows, the developing countries with current-account deficits will have no choice but to cut back their imports, even if their debt-service positions are eased by lower interest rates. This will exert further downward pressure on world trade volume—both directly and via multiplier effects—and thus on the need for trade financing through the Euromarkets.

Continued net inflows into the Eurocurrency markets from such sources as the "low-absorbing" OPEC countries must also be questioned. This is in part because the surplus available for investment is shrinking and in part because—in an environment of falling interest rates—asset-maturity preferences may further shift away from the short-term Eurodeposits toward longer-term financial instruments.

Other forces will offset these effects to a degree, however, the summer's risk premiums of Eurodeposits over their domestic counterparts are likely to fade. Central banks have shown an awareness of the need to underpin confidence in the Euromarkets, debt reschedulings have been orderly even if protracted, and the market has survived the Ambrosiano affair as it survived the 1974 failure of the Herstatt bank.

Over the long run, the continued real growth of the Euromarkets is a function of world trade and freedom of capital movements. And, ironically, it is inversely related to the degree of harmonization in monetary policy among countries. Based on these criteria, the markets' real rate of growth seems set to expand again in the mid-1980s. This will depend, however, on fulfillment of the related conditions of a world recovery and a reversal of the current movement towards protectionism.

George de Nemeskeri-Kiss
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Quarterly Euromarket Report

($ billion, end of period)

Total Market Size	**IIIQ/81**	**IVQ/81**	**IQ/82**	**IIQ/82**	**1979**	**1980**	**1981**
Gross Size (Claims)	1,424.0	1,550.2	1,559.1	1,570.0	1,111.0	1,321.9	1,550.2
Net Size (Claims)	875.0	945.0	945.0	965.0	665.0	810.0	945.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	293.1	303.2	303.8	309.4	269.7	287.5	303.2
Liabilities to Private Nonbank Foreigners	90.6	94.3	97.0	105.5	65.9	75.0	94.3
Total Claims on Foreigners	422.2	445.7	457.0	469.6	324.2	385.4	445.7
Claims on Foreign Public Borrowers	55.0	59.4	60.0	65.2	42.0	48.9	59.4
Claims on Foreign Private Nonbank Borrowers	148.7	161.3	162.8	165.2	117.8	139.9	161.3

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.
Source: Chase Manhattan Bank estimates based on BIS and national data sources.